SUMMARY of COOPERATIVE CASES

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UNITED STATES DEPARTMENT OF AGRICULTURE
FARMER COOPERATIVE SERVICE

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SPECIAL NOTICE

Cumulative Index for the calendar year 1959 is included at the end of this issue, following page 67. Table of Cases Reported is also included.

TIME WITHIN WHICH "NONEXEMPT" COOPERATIVES MUST MAKE ALLOCATIONS OF PATRONAGE REFUNDS.

(Farmers Cooperative Co. 33 T.C. No. 30 (1959))

A nonexempt farmer cooperative must "allocate" (meaning both apportionment and notice to the individual patron of the amount apportioned to him) its patronage refund by the date its return is due, or such refund may not be excluded from the cooperative's gross income, the Tax Court has decided in this case.

The Court recognizes that the Internal Revenue Service had not, prior to the case, made directly applicable to a taxable cooperative the same definition of the term "allocation" as set forth in the regulations relating to exempt cooperatives, except to the extent found in the regulations governing the filing of information returns. Nevertheless, it feels that the petitioner "has failed to show that the requirements imposed by the respondent's regulations are in any way unreasonable or inconsistent with the provisions of the Internal Revenue Code, or are otherwise invalid."

The essential facts were these:

> "On its income tax return for 1953, the petitioner claimed an exclusion from its gross income for patronage refunds in the total amount of $2,415.35. On its return for 1954, it claimed an exclusion from gross income for patronage refunds in the amount of $10,470.72.
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> "The petitioner's only function was to market grain for its members. The patronage refunds excluded by petitioner for 1953 and 1954 were charged against income realized from transactions with the particular patrons who were entitled to receive the refunds, not out of income realized from transactions with nonpatrons. The patronage refunds, when allocated, were made ratably to the individual patrons in proportion to the amount of grain sold by each of them to the petitioner, and were made pursuant to an existing obligation on the cooperative to make certain refunds of earnings.

"The stockholders of petitioner who were present at its annual meeting held on March 12, 1954, were notified of the total patronage dividend in the amount of $2,415.35 for 1953. However, the individual patrons of petitioner were not notified of the dollar amounts of their separate patronage refunds for 1953 until February 10, 1955.

"The stockholders of petitioner attending its annual meeting on February 28, 1955, were notified of the total patronage dividend in the amount of $10,470.72 payable for the year 1954. The individual patrons were not notified of the amounts of their patronage refunds for 1954 until October 10, 1956."

The Court's opinion on these facts is set forth in full as follows:

"The respondent has taken the position that the patronage refunds claimed by the petitioner on its income tax returns for 1953 and 1954 are not excludable. The petitioner is not an exempt farmers' cooperative under section 101(12) of the 1939 Code or section 521 of the 1954 Code. Neither the 1939 Code nor the 1954 Code expressly provide for the exclusion from gross income of patronage dividends, refunds, or rebates by a taxable cooperative association. However, it has been the long-established administrative policy of the Commissioner to permit the exclusion of true patronage dividends by nonexempt cooperatives under certain conditions. I. T. 1499, I-2 C.B. 189, 191 (1922); A.R.R. 6967, III-1 C.B. 289 (1924); S.M. 2595, III-2 C.B. 238 (1924); G.C.M. 12393, XII-2 C.B. 398 (1933); G.C.M. 17895, 1937-1 C.B. 56; I.T. 3208, 1938-2 C.B. 127; Rev. Rul. 57-59, 1957-1 C.B. 24.

"The respondent's practice in permitting the exclusion of patronage dividends by taxable cooperatives is recognized both in section 101(12)(B) of the 1939 Code and in section 522(b)(2) of the 1954 Code, which provide that patronage dividends, refunds, and rebates to patrons with respect to their patronage shall be taken into account in computing net taxable income (of an exempt cooperative) in the same manner as in the case of a cooperative organization not exempt.

"The basis for the Commissioner's policy in allowing the exclusion of patronage dividends by nonexempt cooperatives is that such dividends in reality represent either rebates to patrons of a part of the price initially paid by them on purchases

made through a cooperative purchasing organization, or an additional cost paid by a cooperative marketing organization to its patron for products sold to it. The propriety of the respondent's practice in permitting such exclusions by nonexempt cooperative associations has been recognized and sustained by this and other courts. Midlahd Cooperative Wholesale, 44 B.T.A. 824; Fruit Growers Supply Co., 21 B.T.A. 315, affd. 56 F. 2d 90; United Cooperatives, Inc., 4 T.C. 93; Clover Farm Stores Corportation, 17 T.C. 1265; Farmers Cooperative Co. v. Birmingham, (N.D. Iowa) 86 F. Supp. 201

"The foregoing decisions indicate that an allocation of earnings by a cooperative to its patrons cannot qualify as a true patronage dividend unless (1) the allocation was made pursuant to a legal obligation which existed at the time the participating patrons transacted their business with the cooperative, (2) the allocation was made out of profits or income realized from transactions with the particular patrons for whose benefit the allocation was made, and (3) the allocation of earnings was made ratably to the particular patrons whose patronage created the income from which the allocated refund was made. Pomeroy Cooperative Grain Co., 31 T.C. 674; Clover Farm Stores Corporation, supra; Farmers Cooperative Co. v. Birmingham, supra.

"The petitioner maintains that it has satisfied all three of these requirements and is therefore entitled to exclude from its gross income the amounts claimed by it as patronage dividends on its income tax returns for 1953 and 1954.

"The respondent does not question the existence of a legal obligation pursuant to which the refundable earnings were set aside, and he also concedes that the patronage dividends in question were withdrawn from income realized from transactions with the patrons who were entitled to receive the refunds. He contends, however, that petitioner has lost its right to exclude the amounts claimed on its returns as patronage dividends for 1953 and 1954 because it has failed to make a proper and timely allocation of earnings. The respondent points to the provisions of his regulations governing the allocation of such refunds by an exempt cooperative,1/ which explicitly require that actual

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1/ (3) Allocation. The term "allocation" includes distributions made by a cooperative association to a patron in cash, merchandise
(Continued)

notice be given to each patron of the amount of his separate share of the total patronage refund. Although these provisions of the respondent's regulations do not apply directly to a taxable cooperative association, the same definition of the term "allocation" as set forth in the above-cited provisions is made applicable to nonexempt cooperatives as well as exempt cooperatives by other provisions in the respondent's regulations governing the filing of information returns by any corporation allocating $100 or more in patronage refunds during the taxable year. Regs. 118, sec. 39.148(f)-1(d); Income Tax Regs., sec. 1.6044-1(c).

"The petitioner concedes that the actual notice to its patrons required by the respondent's regulations was not given until a considerable period of time after its returns for 1953 and 1954 were filed. It contends, however, that the provision in the respondent's regulations requiring actual notice to a patron of the dollar amount of his share of the patronage dividend bears no reasonable relation to the excludability by a cooperative of patronage dividends and is therefore invalid. In support of its position, the petitioner asserts that neither this nor any other court has laid down such a requirement and, further, that as an accrual basis taxpayer, it is entitled to a deduction for an accrued liability for the year in which such liability actually accrued, regardless of whether or not the creditor was apprised of the accrual.

"The petitioner, however, has failed to show that the requirements imposed by the respondent's regulations are in any way unreasonable or inconsistent with the provisions of the Internal Revenue Code, or are otherwise invalid. See Manhatten General Equipment Co. v. Commissioner, 297 U.S. 129; Faucette Co., 17 T.C. 187; Selma Berry Trust, 26 T.C. 344.

Footnote continued
capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, similar documents, or in any other manner whereby there is disclosed to a patron the dollar amount apportioned on the books of the association for the account of such patron. Thus, a mere credit to the account of a patron on the books of the cooperative associations, without disclosure to the patron, is not an allocation. [Regs. 118, sec. 39.101(12)-2(b)(3); Income Tax Regs., sec.1.522-1(b)(3).]

"It is of course a generally correct statement of the law, as petitioner contends, that an accrual basis taxpayer must deduct its expenses in the year in which the deductible expenses are incurred. It is axiomatic, however, that an item of expense has not properly accrued as a deductible expense for income tax purposes unless all of the events necessary to establish the right to a deduction of the item have occurred in the taxable year for which the deduction is claimed. United States v. Anderson, 269 U.S. 422; Anderson-Clayton Securities Corporation, 35 B.T.A. 793. In the case of cooperatives an accrued patronage dividend must either be allocated or paid to the patrons prior to the time for the filing of the return if the dividend is to be excludable. Pomeroy Cooperative Grain Co., supra; Clover Farm Stores Corporation, supra. The fact that a patronage refund was accrued by the cooperative in favor of its patron is not alone sufficient to establish the excludibility of the refund. The record before us does not show that the patronage dividends here in question were either allocated or paid by petitioner to its patrons prior to the prescribed time for the filing of its income tax return. Consequently, the petitioner has failed to demonstrate that the events necessary to establish the excludability of the patronage refund in question have occurred prior to the due date of its return.

"Although the respondent has not suggested the purpose of the requirement of its regulations concerning notice to a patron of a cooperative, it seems altogether likely that such a requirement might well serve a useful purpose by insuring notification to nonmember patrons who would not normally have the privilege of attending meetings of the association or inspecting its books and would therefore be unable to ascertain the amount of refund, if any, to which they would be entitled. Further, the pattern of taxation adopted by Congress in section 101(12)(B) of the 1939 Code and section 522(b)(2) of the 1954 Code, with respect to the taxation of the refundable earnings of exempt cooperative associations indicates a congressional intent to tax to the individual patron his share of a patronage refund deducted by the cooperative. S. Rept. No. 781, 82d Cong., 1st Sess. (1951), p. 21; cf. Long Poultry Farms v. Commissioner, 249 F. 2d 726, reversing 27 T.C. 985. Cooperative earnings not paid or allocated to patrons are taxable to the cooperative association. S. Rept. No. 781, 82d Cong., 1st Sess. (1951), p. 21. The provisions of the respondent's regulations here in question would have the effect of increasing

the likelihood of an early inclusion, as accrued income or an item constructively received by a patron, of his share of a patronage dividend credited to him and deducted by a co-operative.

"Section 522(b) of the 1954 Code specifically requires allocations of patronage dividends by exempt cooperatives to be made by the date the return is due. See Section 6072(d), 1954 Code. The portion of the respondent's regulations here in question (Regs. 118, sec. 39.101(12)-2(b)(3) and sec. 39.148(f)-1(a) and (b); Income Tax Regs., sec. 1.522-1(b)(3) and sec. 1.6044-1(a) and (b)) read in conjunction with section 53(a)(1) of the 1939 Code and section 6072(b) of the 1954 Code require a taxable cooperative association to pay or allocate patronage refunds by the time its return is due if such refund is to be excludable. To sustain the contentions advanced by the petitioner would result in extending to a non-exempt cooperative association a privilege which clearly would be denied an exempt cooperative under the terms of the Code and the respondent's regulations. We are unable to find any reason for so holding.

"Accordingly, since the petitioner's patrons concededly were not notified of the amount of the patronage refund to which they were entitled for 1953 and 1954 prior to March 15, 1954, and March 15, 1955, respectively, the petitioner has failed to make a proper and timely allocation of its patronage dividends for those years, and the exclusions which it claimed on its income tax returns for 1953 and 1954 for patronage dividends must be disallowed."

(See, in this connection Rev. Rul. 59-322,set forth in Summary Legal Series No. 10, September 1959, which, presumably, will still be followed by the Internal Revenue Service, despite the foregoing decision. Whether Internal Revenue Service, on the basis of this decision, may issue deficiency assessments on refunds not complying with Revenue Ruling, could not be ascertained).

MONOPOLIES AND RESTRAINT OF TRADE - CONTRACT ASSIGNING TERRITORY AMONG MILK HAULERS

(Okerberg v. Crable, Kan. , 341 P.2d 966 (1959))

A contract entered into between a number of independent milk haulers transporting milk from farms of producers to a single creamery, which assigned the territories among the haulers and imposed other regulations on the haulers was held not in restraint of trade or contrary to public policy under Kansas law. The court applied what it terms "the modern doctrine of reasonableness" and found that any restraint involved here was not unreasonable because (1) the regulations set up under the contract worked no hardship on the producers being served but, on the contrary, promoted their best interests; (2) the producers could, if they wished, haul the milk themselves or sell to another outlet; and (3) there was no fixing of prices of the milk. The case did not involve any charge of violation of Federal law.

For a number of years prior to February, 1957, plaintiff and defendants were signatories, along with about 30 other haulers, to a contract establishing milk route territory regulations applicable to their routes. Bennett Creamery Company, although not a party, acquiesced in the territorial division and the regulations adopted.

The contract provided, in substance, that "milk routes were to be recognized by number and color, and when routes overlapped roads should be colored to denote route territory on a route map to be kept and locked in a glass case in the haulers' office at Bennett's plant; any route change was to be made by not less than 'three committee members' at the request of the haulers desiring the change and with all affected haulers present; a hauler had to serve all producers in his territory who sold to Bennett and he would be penalized if he forfeited a producer's business; far-reaching routes would be protected from encroachment by new and nearer routes; * * * . The remaining portion of the contract required the regulations to be signed by all haulers and posted with the route map, indicating their acceptance of both."

In February, 1957, in order to provide for a more modern and efficient method of hauling milk from refrigerated bulk tanks on producers' farms via a hauler's bulk tank truck to Bennetts, an additional paragraph (Item 10) was added to the regulations whereby it was agreed that tank hauling rights could be sold and transferred by a can hauler to a bulk tank hauler under one of two proposed payment plans. The payment plan involved in the suit was the first, or cash, payment plan, under which cash was to be paid within thirty days after the first bulk tank hauling and was to be computed at the "minimum rate of 50 cents per pound average of previous 12 months daily average weight." The average weight was determined by dividing the total pounds of milk produced during the previous twelve months by 365 or if the period was less than 12 months, by dividing the total number of pounds by the number of days shipped. Such sales to a purchasing hauler were to be final and binding and without recourse except that if a bulk tank farmer-producer reverted to cans within 12 months, then the territory owner (can hauler) had to refund the prorata share of the purchase price to the bulk tank hauler. If the change back to cans occurred after a year then no refund was to be made but the bulk tank hauling rights were not thereby lost to the tank hauler or his successor.

Item 10 further provided that the Haulers' Committee would decide any bulk tank question not covered by Item 10. At least ten haulers were required to call a meeting of route owners and a two-thirds majority of all route owners was required to change the regulations. A total of 34 haulers, including appellant and both appellees, signed the regulations.

As a result of a conversion by three of plaintiff's producers from the can to the bulk tank system, plaintiff transferred these producers to the defendants' bulk tank routes. Defendants, however, failed and refused to make the payments called for by the contract, contending that it was illegal either as being (1) in restraint of trade under Kansas law; or (2) in violation of the State's public policy.

After citing and discussing a number of Kansas cases, the court said:

> "The Heckard case recognized that no 'hard and fast' rule governing all such contract cases can be laid down. 164 Kan.at page 223, 188, P. 2d at page 931. The court there held:

> 'The old rule as to limitations of time and space with respect to contracts involving restraint of trade has given way to the modern doctrine of reasonableness and the real test is never whether there is any restraint but always whether the restraint is reasonable under the facts and circumstances of the particular case.' (Syl.par.7.)

"In the Heckard opinion, similiarly to our present case, the solution of the question of reasonableness of a contract of the character there being considered was said to depend 'upon fundamental elements of common fairness in view of the facts and circumstances of the parties.' 164 Kan. at page 224, 188 P. 2d at page 933.

"Some of the circumstances to be considered in determining the fundamental elements of common fairness of the regulations in this case are that under finding eleven all of the producers of milk, none of which is a complaining party here, are generally charged the same hauling rates within a particular route territory of a can hauler whether the milk goes to Bennetts or some other plant and irrespective of the distance from the farm to the receiving plant. Thus the regulations did not work any hardship on the milk producers. On the other hand the producers had access, if they desired it, to the regular service of a hauler who knew and traveled all types of roads under all weather conditions, with proper equipment, so that the milk was picked up at approximately the same time every day if they used cans, or once every two days if they used the bulk tank system. Without such system and orderly regulations there would be overlapping of territories, excessive distances to be covered by haulers, and other circumstances whereby the producers could not be positive that all or any of the milk produced would reach its destination or what its condition would be when it arrived. As we view the regulations, the fundamental elements of common fairness, so far as the milk producers are concerned, are well established.

"The appellees through the regulations here being considered have been and now retain their territory as can haulers along with the three customers of appellant they obtained by reason of Item 10. Under the reasoning of the Heckard case, this is not inimical to our 'restraint of trade' statutes or public policy.

"We cannot agree with the trial court's second conclusion of law that the regulations had the purpose and effect of eliminating competition for the transportation of milk by third parties. So far as Bennetts and the signers of the regulations are concerned, the producers could haul their milk themselves, if they preferred. The entire plan is based on competition, as heretofore stated, and further discussion is unnecessary on this point.

"From previous discussions we think that the trial court's findings do not support the third conclusion of law since there is no price-fixing of the milk or requirement that the producer must sell to Bennetts. At no time does the milk become the property of the hauler. Appellees have cited United States v. Nationwide Trailer Rental System, D. C., 156 F. Supp. 800, affirmed per curiam, 355 U.S. 10, 78 S. Ct. 11, 2 L. Ed. 2d 20, which is not controlling here because a federal law was there involved. That case shows what appellees contend and the trial court concluded as to the purpose and effect of these regulations but a careful study of that case shows the distinction between a void agreement, as there, and a valid and reasonable set of regulations such as we have here.

"In regard to the fourth conclusion of law [which was that the agreement 'being contrary to the declared public policy of the State is presumed to be injurious to the public welfare'] we believe our previous discussion has determined it was not proper and especially is this true on the point of a presumption. They must be in favor of the validity of the regulations and not the invalidity thereof. The burden at all times was on the appellees to prove the invalidity of the regulations."

STATE RESTRICTIONS ON CERTAIN MERCHANDISING PRACTICES

BY WHOLESALERS OF DAIRY PRODUCTS HELD VALID.

(Borden Co. v. McDowell, Wis. , 28 L.W. 2201 (1959))

Wisconsin statutes restricting "selected dairy products" wholesalers from furnishing special services, equipment, advertising material, and credit to their retailer-customers do not violate due-process or equal-protection prerogatives of large wholesalers using such merchandising practices, according to the Supreme Court of Wisconsin. Accordingly, they were held to be a valid exercise of the State police powers. The statutes in question define "selected dairy products" to include milk, cream, ice cream, frozen deserts, ice milk, and sherbet.

The large distributors presented evidence that the proscribed distribution practices had been used for many years. They contended that the practices had promoted healthy growth of the dairy industry with resulting benefits to the public, with no intention nor tendency toward monopolizing the wholesale commerce in these products. The court said, however, that this case should not be decided by the preponderance-of-the-evidence principle. The enactment of the restricting legislation is an attempt to exercise state police power to promote the public welfare. Under these circumstances, the weight of the evidence does not conclude the legislative judgment as it may conclude the appellate court in the usual case.

There was also substantial evidence of specific instances where large distributors, by furnishing new equipment or making substantial loans, obtained new customers. Such loans or aids may be, and in fact sometimes are, comparable to subsidies. It is, therefore, apparent that at the retail level and unsubsidized dealer cannot compete with one who is subsidized. Such practices may, in the judgment of the legislature, be considered unfair trade practices. Therefore, the legislature may feel that the prohibition or regulation of such practices will enable the wholesalers of limited resources to compete for the retailers' trade on a more equitable basis.

The court noted Fairmont Foods Co. v. Burgess, 81 N.W. 2d 636, where the North Dakota Supreme Court had declared unconstitutional

a statute very similar to the one involved in this case. However, it apparently felt that the sister State decision, although entitled to respect, did not accord with Wisconsin's precedents "in recognizing facts and purposes that Wisconsin courts must assume the legislature had in mind."

TAX REVISION PAPERS ON TAX TREATMENT OF FARMER COOPERATIVES

The Committee on Ways and Means has recently released a three volume committee print entitled "Compendium of Papers on Broadening the Tax Base" and is now holding oral panel discussions on the subjects covered by the compendium. One of the subjects is the taxation of cooperatives - particularly farmer cooperatives.

Volume 3 contains seven papers on this subject. The contributors are: Fred W. Peel, Jr., Attorney, Washington, D.C.; William C. Warren, Dean of Columbia Law School, N.Y.; Leo J. Raskind, Associate Professor of Law, Vanderbilt University, Nashville, Tenn.; Samuel J. Lanahan, Attorney, Washington, D.C.; Roswell Magill, Attorney, N. Y.; Wilifrid E. Rumble, Attorney, St. Paul, Minn.; and Charles E. Nieman, Attorney, Minneapolis, Minn.

The papers run the gamut of all suggestions previously considered for taxing cooperatives, plus several which, although perhaps not new, at least represent "new frills on old dresses."

In the lead-off paper, Mr. Peel suggests the following Federal income tax treatment for consumer and farm cooperatives and their patrons:

1. No tax should be imposed on the receipt of patronage refunds on purchases for personal use.

2. Cooperatives should be permitted to exclude or deduct patronage refunds.

3. There should be no gap between the time patronage refunds are excluded or deducted by the cooperative and the time they are reported as income by the patrons.

4. Patronage refunds should be excluded or deducted by cooperatives and reported as income by patrons when they are distributed in cash.

5. Farm cooperatives should be required to withhold tax at the rate of 20 per cent from patronage refunds.

6. Cooperatives should be taxable as ordinary corporations on their income from outside sources.

7. The exemption of farmer cooperatives should be eliminated.

Dean Warren argues that patronage dividends represent a distribution of profits and that the exemption provisions relating to cooperatives should be repealed. He advances three suggestions for study:

1. Tax cooperatives on their "net trading margin" unreduced by patronage dividends allocated to patrons.

2. Adopt an approach similar to the one used in Canada. (He explains that: "Under the Canadian statute a cooperative is exempt from tax for the first 3 years of its existence. After 3 years, cooperatives must pay the regular corporate tax. A deduction is allowed for the payment of patronage dividends. However, the deduction is limited to an amount which will not reduce the taxable income of the cooperative to less than 3 per cent of the capital employed, less certain deductible interest. The theory underlying this approach is that patronage dividends represent, at least in part, a distribution of profits derived from invested capital. An arbitrary rate of return on capital of 3 per cent is used to fix this amount.")

3. Split the margins, in effect, into two parts and treat each part according to its character. He states:

> "To the extent that a cooperative's income is derived from activities not directly related to transactions with patrons, the distribution of patronage dividends more closely resembles a distribution of profits than a rebate. Therefore, they should not reduce the cooperative's taxable income. On the other hand to the extent

> that a cooperative's income is derived from its transactions directly with its patrons, it would not seem unreasonable to permit patronage dividends to be treated as rebates. While this approach would present difficulties in defining 'unrelated business' and determining the amount of income therefrom, these difficulties are not insurmountable. Similar problems, although less complex, have been met by Congress by arbitrary classification."

Mr. Raskind makes an analysis of the "money-flows with which the cooperative is concerned" and compares operations under present law with "a model for the functional characterization" of such flows. He concludes that his analysis requires that a special tax treatment of a cooperative business unit "be limited in application to those cooperatives whose receipts may be characterized as primarily a return for the performance of services. Where the receipts of a cooperative business unit are largely in the nature of a return to invested capital, the appropriate tax treatment is that of the ordinary business association. Insofar as there are practical limitations in applying the analytical criteria to distinguish between the two classes of receipts and since the present statutory definitions are fundamentally in accord with these criteria, the immediate concern is with removing existing defects in the statute. Two changes are recommended for immediate action: elimination of the muddle surrounding paper distributions and the modification of the existing statutory classification of exempt and nonexempt cooperatives."

Mr. Lanahan makes two "complementary proposals" for the taxation of cooperatives:

"(1) Impose a tax at the corporate rate on the income of cooperatives which is derived from manufacturing and processing.

"(2) After subtracting the income, if any, subject to tax under the first proposal, net margins attributable to patronage of members will also be taxed at the corportate rate to the extent that they are not distributed currently as patronage dividends. An offsetting credit system is provided, however, in order that the cooperative may not be subject to any tax, under the second proposal, when such retained net margins are in fact distributed in cash."

Mr. Roswell Magill has not changed his views, which are reasonably well known since his Michigan Law Review article of 1950. He thinks:

> "A cooperative should be taxable on its income, whether or not it issues to its patrons certificates evidencing net margins in some amount, such certificates being only payable in the discretion of directors at some wholly indefinite time in the future."

Mr. Rumble presents factual information concerning cooperatives, their method of operation, their importance to the economy, and the past and present tax treatment of cooperatives and their patrons. He also considers whether Congress can under the Constitution of the United States tax net margins of cooperatives which are subject to a proper prior mandatory obligation and concludes that it cannot subject such margins to an income tax. As to taxing the cooperatives, he concludes:

> "Fairness to farmers, a due regard to the welfare of all of the people, and above all recognition of the obvious and admitted difference in the nature of the cooperative business corporation as compared with the private profit corporation, compellingly requires a continuation of the long-established congressional and Treasury Department treatment of cooperatives for income tax purposes."

As to patrons Mr. Rumble concludes:

> 1. The net margins of cooperatives (except those growing out of purchases made for personal use) should be taxed to patrons in accordance with the intent of Congress when the 1951 amendment was adopted.
>
> 2. The appropriate provisions of the Code should be amended so as to avoid the court decisions which have largely nullified the intent of Congress and the longstanding rule of the Treasury Department.

Specifically, on the latter point, he suggests an amendment which would"provide that all earnings of qualified cooperatives should be included in the gross income of patrons (except those growing out of purely personal purchases) provided they are

distributed to patrons pursuant to a preexisting obligation and accepted by the patron in satisfaction of that obligation, and that such distributions should be considered to have been accepted by patrons in satisfaction of the cooperative's obligation if the articles of incorporation, bylaws, or similar documents so provide, or if the cooperative shall have given written notice so providing at or prior to the transaction out of which the refund arises, and thereupon to have been invested in the cooperative. I think such a law would be enforcible and would meet with the approval of most cooperatives and their patrons. Those cooperatives which did not approve of it would not be compelled to accept it nor would their members. A majority of the members could by appropriate action at a membership meeting make the law inapplicable to them and to their cooperative. In such event the amendment would require the cooperative to include as income the rejected distributions. With such congressional blessing of the reinvestment principle, I think no court could say the principle was a fiction. I am confident the law would be sustained by the courts."

Mr. Nieman's analysis leads him to these conclusions:

"(1) The operations of a cooperative association ordinarily result in the realization of income by someone;

"(2) that income should be reported as such by the taxpayer, either the cooperative or its patron, who derives the income;

"(3) that both the question of whether income results from the operations of a cooperative and, if so, the further question of who - the association or its patrons - derives that income should be determined by the same rules which apply to other taxpayers and with a decent regard for fundamental principles of law;

"(4) that the so-called exemption available to farmer cooperatives under section 521 and the tax treatment prescribed by section 522 are fully justified by the public interest, and my principal criticism of those sections is that they do not provide enough incentive to induce more cooperatives to accept the limitations and restrictions which are conditions precedent to qualifying for such status and treatment."

FINAL REGULATIONS ISSUED ON TREATMENT OF PATRONAGE DIVIDENDS FROM COOPERATIVE ASSOCIATIONS

On November 30, 1959, T.D. 6428 and T.D. 6429 were issued. These appear in the Federal Register for December 3, 1959 (24 F.R. 9663 and 9661, respectively). The decisions amend the rules with respect to the tax treatment of patronage refunds to conform them to the decisions in Long Poultry Farms, Inc. v. Commissioner, (C.A. 4th 1957) 249 F. 2d 726, and Commissioner v. B.A.Carpenter, (C.A. 5th 1955) 219 F. 2d 635. T.D. 6428 amends 26 CFR Part 1 § 1.61-5, relating to taxable years beginning after December 31, 1953. T.D. 6429 makes comparable amendments to 26 CFR (1939) Part 39 § 39.22(a)-23 covering taxable years beginning after December 31, 1951, and before January 1, 1954, and also makes such amendments applicable to taxable years beginning after December 31, 1941, and before January 1, 1952.

The essence of the final rules (minus some illustrative examples) is apparent from the following excerpts from T.D. 6428:

§ 1.61-5 Allocations by cooperative associations; tax treatment as to patrons.

* * *

(b) Extent of taxability. (1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services, the cost of which was deductible by the patron under section 162 or section 212, shall be included in the computation of the gross income of such patron, as ordinary income, to the following extent:

(i) If the allocation is in cash, the amount of cash received.

(ii) If the allocation is in merchandise, the amount of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of revolving fund certificates, retain certificates, certificates of

indebtedness, letters of advice, or similar documents, the amount of the fair market value of such documents at the time of its receipt by the patron. For purposes of this subdivision, any document containing an unconditional promise to pay a fixed sum of money on demand or at a fixed or determinable time shall be considered to have a fair market value at the time of its receipt by the patron, unless it is clearly established to the contrary. However, for purposes of this subdivision, any document which is payable only in the discretion of the cooperative association, or which is otherwise subject to conditions beyond the control of the patron, shall be considered not to have any fair market value at the time of its receipt by the patron, unless it is clearly established to the contrary.

(iv) If the allocation is in the form of capital stock, the amount of the fair market value, if any, of such capital stock at the time of its receipt by the patron.

(2) If any allocation to which subparagraph (1) of this paragraph applies is received in the form of a document of the type prescribed in subparagraph (1) (iii) or (iv) of this paragraph and is redeemed in full or in part or is otherwise disposed of there shall be included in the computation of the gross income of the patron, as ordinary income, in the year of redemption or other disposition, the excess of the amount realized on the redemption or other disposition over the amount previously included in the computation of gross income under such subparagraph.

(3) (i) Amounts which are allocated on a patronage basis by a cooperative association with respect to supplies, equipment, or services, the cost of which was not deductible by the patron under section 162 or section 212, are not includible in the computation of the gross income of such patron. However, in the case of such amounts which are allocated with respect to capital assets (as defined in section 1221) or property used in the trade or business within the meaning of section 1231, such amounts shall, to the extent set forth in subparagraph (1) of this paragraph, be taken into account

by such patron in determining the cost of the property to which the allocation relates. Notwithstanding the preceding sentence, to the extent that such amounts are in excess of the unrecovered cost of such property, and to the extent that such amounts relate to such property which the patron no longer owns, they shall be included in the computation of the gross income of such patron.

(ii) If any patronage dividend is allocated to the patron in the form of a document of the type described in subparagraph (1)(iii) or (iv) of this paragraph, and if such allocation is with respect to capital assets (as defined in section 1221) or property used in the trade or business within the meaning of section 1231, any amount realized on the redemption or other disposition of such document which is in excess of the amount which was taken into account upon the receipt of the document by the patron shall be taken into account by such patron in the year of redemption or other disposition as an adjustment to basis or as an inclusion in the computation of gross income, as the case may be.

(iii) Any adjustment to basis in respect of an amount to which subdivision (i) or (ii) of this subparagraph applies shall be made as of the first day of the taxable year in which such amount is received.

* * *

(c) Special rule. If, for any taxable year ending before the date of publication of this paragraph in the FEDERAL REGISTER as a Treasury decision, a taxpayer treated any patronage dividend received in the form of a document described in paragraph (b)(1)(iii) or (iv) of this section in accordance with the regulations then applicable (whether such dividend is subject to paragraph (b) (1) or (3) of this section), such taxpayer is not required to change the treatment of such patronage dividends for any such prior taxable year. On the other hand, the taxpayer may, if he so desires, amend his income tax returns to treat the receipt of such patronage dividend in accordance with the provisions of this section, but no provision in this paragraph shall be construed as extending the period of limitations within which a claim for credit or refund may be filed under section 6511.

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